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# Financial Risk&Regulation

## Managing divergence in the fund management sector

Newsletter – November 2023

Nowadays there are many external challenges facing the asset management industry, including demands for sustainable finance, volatility in capital markets, technological innovation, and cyber threats. Thus, firms need to adopt resilient and dynamic business models if they are to be successful. This can also prepare them for the regulatory changes that, together with market and technological processes, create ever faster and more complex expectations.

In this fast-changing environment, regulators globally are focusing on common themes: They implement detailed rules and guidance differently because of the need for global standards. This increasing regulatory divergence is causing complexity and challenges for cross-border asset managers regarding how they manage and market their products.

In the past year, regulators and EU legislators have responded to the main challenges affecting the securities market, such as increasing the transparency of sustainable investments, mitigating systemic risks caused by the increasing share of non-bank players in global financial instruments, greater reliance on third-party suppliers, which raises concerns about the concentration exposure of asset management companies. These circumstances force both regulators and companies to constantly change and adapt. Regulators must be open to the new challenges of technology and place a strong emphasis on investor education and fraud protection efforts to mitigate behavioral risks and prevent damage from fraud caused by the use of evolving technologies. Companies also must stretch their business models in order to overcome uncertainties, respond quickly to new market opportunities, maintain compliance with regulations and protect investors' assets.

Below we provide an overview of the main regulatory changes affecting the fund and asset management sector.

## Evolving frameworks and priorities

Regulators must respond to both global and regional priorities. Some are introducing fundamentally new regulatory frameworks for the industry or undertaking significant reviews of existing ones.

The Financial Stability Board (FSB) 2023 work program reflects its global and cross-sectoral approach to financial stability policy. It highlights global challenges that affect the overall financial system, including digitalization, climate change, and the consequences of shifts in the macroeconomic and interest rate environment.

International Organization of Securities Commissions (IOSCO) 2023/24 work program closely mirrors the FSB's priorities, among others, strengthening financial resilience, supporting market effectiveness, protecting investors, and addressing new risks in sustainability and fintech.

As for the fund management sector in the EU, the 2011 AIFMD (Alternative Investment Fund Managers Directive) framework has been reviewed and is to be expanded. Key elements subject to change are: the governance of the fund management company, the delegation of critical functions, remuneration policies to be consistent with long-term risks, the assessment of undue levels of cost, the liquidity management tools, the leverage reporting, the regulation of loan-originating and the effective removal of the depositary passport. For fund managers, the regulation on cost levels can be a significant change.

## Deliver sustainable finance

Initiatives relating to enhanced reporting aim to capture more firms and products in the capital market ecosystem and to increase the flow of information from companies to stakeholders, including asset managers.

Although the EU encourages and facilitates much-needed additional financial flows into sustainable investments by publishing a package of measures to strengthen the foundations of its existing and detailed sustainable finance framework a stark contrast is emerging in the financial services regulation between the EU and the rest of the world. This makes it more difficult for firms to run the same investment strategies in multiple jurisdictions.

Although the regulators all have the same goal of mitigating greenwashing, their scope and approach are fundamentally different. While the ESG disclosures proposed by the US SEC are rule-based, the EU's approach is more principles-based. The EU Sustainable Finance Disclosure Regulation (SFDR) has extra-territorial impacts, given that fund managers marketing into the EU are in scope.

***EU focuses on tackling greenwashing and promoting sustainable finance through its above-mentioned regulation framework by the following steps:***

The EU has completed its detailed environmental taxonomy. It has added technical screening criteria for water and marine resources, recycling and re-use, pollution prevention, and biodiversity and ecosystems.

The EU SFRD also continues to evolve. These credible European labeling regimes with robust standard criteria would clarify on the investment options for investors to decide if and how to contribute to financing the transition.

Proposed EU requirements on corporate sustainability due diligence would require certain companies to identify and prevent, end, or mitigate the actual and potential impacts of their activities on the environment and human rights abuses.

***What should firms do?***

First and foremost evaluate the firm's product range and governance framework in the context of new regulation framework. Besides that, firms might harness the benefits of a technology-driven approach. Also, carry out a product scoping and classification exercise against relevant labeling requirements and implement a common framework across the firm to define which products qualify as "sustainable" and embed sustainability considerations. Review the approach to stewardship and assess whether appropriate technology for monitoring and reporting engagement is in place.

## Mitigate systemic risk

Systemic risk continues to be an essential regulatory priority. Regulators explore potential risks and vulnerabilities in new areas, such as private markets and crypto assets.

Asset managers play an increasingly important role in financial markets and funding the real economy. A recent area of focus in Europe has been the liability-driven investment strategies (where the goal of investing is to make sure that an investor with long-term financial commitments such as a pension fund or insurance company has the income-generating assets it needs to satisfy its financial obligations (e.g., payouts to plan participants and customers making claims) but usually offer lower return compared to equities). Use of leverage, investments in private and tangible assets, and asset valuation are also  at the top on the regulatory agendas.

The EU regulators noted the need to monitor liquidity risks arising from investments in leveraged funds and funds using interest rate derivatives. The CBI (Central Bank of Ireland) was the first EU national regulator to use the power under AIFMD to impose leverage limits where there could be potential risks to financial stability.

The EU's AIFMD review has introduced the definition of a loan-originating fund and the amount of risk they should retain, as well as a leverage cap designed to mitigate potential financial stability risks. Loan-originating funds are designed to provide credit as sole or primary lenders to borrowers.

***What should firms do?***

Tighten up governance arrangements and evaluate the effectiveness of the stress testing process. For ETF managers, review and implement IOSCO's good practices. Review asset valuation policies and procedures. Consider preparedness for new reporting obligations and revise systems, roles, and responsibilities as needed. Re-assess due diligence arrangements over index and data providers and ensure each party's roles and responsibilities are clear.

## Double-down on resilience

There are new requirements for protecting against cyber threats, enhancing operational resilience, and overseeing outsourced activities.

To complement the incoming Digital Operational Resilience Act (DORA), which is applicable in January 2025, EU regulators consulted on criteria for critical ICT third-party service providers. DORA will set uniform requirements for the security of the network and information systems of financial services firms and critical third parties. The EU regulatory authorities consulted on regulatory technical standards containing related detailed rules, including criteria for critical ICT service providers. The drafts of the regulatory and implementation technical standards were already published in the first half of the year, and the other half will be published in mid-December.

The FSB sets out 16 recommendations to address practical challenges associated with collecting information about cyber incidents, including setting appropriate and consistent thresholds for reporting.

Information and ICT security are at the top of the agenda for other regulators as well. Besides covering aspects of operational resilience and third-party oversight, the European Supervisory Authorities' (ESA) consultations will contribute to EU efforts to prevent and mitigate cyber threats.

***What should firms do?***

Identify and manage all potential operational risks. Review oversight arrangements over third-party providers. Review information security arrangements. Assess whether sufficient capital and liquidity are held.

## Embrace innovation

Technological innovation remains in the focus of regulators. Firms must consider the potential benefits and risks of new technologies like artificial intelligence.

FinTech and Big Tech received multiple references in recent regulatory outputs, along with artificial intelligence (AI) and machine learning (ML). Regulators are aware of the greater use by investors of social media and online platforms but recognize the risks and potential benefits.

The FSB has finalized a framework for the international regulation of crypto-asset activities. Notably, the EU Markets in Crypto-assets Regulation (MiCA) will start to apply in July 2024.

The use of AI and ML in finance is under scrutiny from regulators. In February 2023, ESMA (European Securities and Markets Authority) issued a report on the use of AI in EU securities markets, which noted that only a few had developed a fully AI-based investment process and publicly promoted their use of AI. The report identified a key risk with increased uptake of such technologies is the concentration of systems and models among a few big players.

A new EU AI regulation has entered the final negotiation stage between the co-legislators (France, Germany and Italy already have come to a consensus). It identifies prohibited practices, prescribes various governance, organizational and transparency requirements, and additional obligations for "high-risk" AI systems.

***What should firms do?***

Explore the possibilities of tokenizing assets and fund units. Track regulatory developments on AI and ML and consider appropriate use cases. Ensure that online marketing and adverts are not misleading. Participate in regulators' efforts to promote innovation and feedback on potential opportunities and risks.

## Protect investors

New conduct frameworks have been introduced to protect and educate investors. Costs and charges are under significant scrutiny, and efforts are being made to bring disclosure and distribution arrangements into line with technological developments.

The EU set out wide-ranging proposals to increase trust, transparency, and investor participation. The proposals would introduce new product governance and value-for-money requirements, simplified disclosures, and further training and competence standards for financial advisers.

The EU has developed its 2018 product governance guidelines to require companies to define their product sustainability objectives, which we have summarized here. ESMA adjusted the requirements for the identification of the investor target market, the distribution strategy and the periodic review of the products, as well as updated its guidelines on remuneration policies and requirements, consideration of conflicts of interest. In addition, it published a supervisory information on the interpretation of the concept of advice according to MiFID. ESMA has also published revised guidance on the suitability assessment of a product recommended to investors, which addresses the role of "sustainability preferences" - how firms should help clients understand the approach, what information they should collect and how they should identify the client's preferences suitable products.

The EU's retail investment strategy includes simplifying disclosures for delivery in electronic format by default and a standardized presentation of costs and charges.

***What should firms do?***

Review the firm's evolving strategy, culture, and purpose. Review governance structures and MI that are used to consider customer outcomes (such as client profiling for MiFID purposes). Check whether a target market for products has been defined with sufficient granularity. Ensure disclosures on costs and charges are understandable and consistent with new regulatory requirements. Challenge whether products are demonstrably meeting clients' needs. Review arrangements with distributors. Ensure that systems and controls are keeping pace with technology developments efficiently.

## Project good governance

Firms' governance arrangements remain a regulatory priority. This year, the focus is on culture, fitness, the probity of individuals (fit&proper), and sufficient "substance" in regulated firms.

Outsourcing of critical functions, such as portfolio and investment risk management, concerns around substance in the delegating firm, and its ability to oversee the third parties to which it delegates are also core themes. Controls to deter financial crime are being strengthened due to global regulatory pressure. As part of firms' investment processes, many regulators emphasize the need for good conduct in wholesale markets, proper due diligence and stewardship of investments.

In Europe, the regulatory spotlight is both on "self-managed" funds – where the fund and the fund management company (FMC) is one corporation – and "host" FMCs (companies that offer to act as the FMCs for funds initiated by third-parties) from governance point of view.

***What should firms do?***

Ensure the compliance function keeps pace with growth in the business. Promote a "speak up" culture. Review the composition of the board. Check the mapping of senior managers' and staff's roles and responsibilities. Review whether there are sufficient resources and expertise at all levels of the business. Review policies and procedures to determine whether appropriate AML due diligence arrangements exist for higher-risk customers. Assess capabilities to identify and manage market abuse risks effectively. Enhance formalized voting policies to disclose voting activity an easy-to-analyze format.

## Seize opportunities

Regulators worldwide continue to create new fund vehicles or amend existing products to offer flexibility and compete for market share. Authorities also aim to bolster investment from professional investors in infrastructure and unlisted companies to assist in economic recovery. Regulators are keen, though, to mitigate potential conduct risks and prevent harm.

The review of EU long-term investment funds (ELTIFs), introduced in 2015 but saw only low take-up, resulted in wide-ranging amendments to the regulation, which will take effect from January 2024. The amendments ease existing restrictions and are intended to make ELTIFs more attractive to set up and invest in and to increase investment in long-term projects.

***What should firms do?***

Factor opening markets and access possibilities into the business and product strategy. Monitor the outcomes of jurisdictions' reviews of fund regimes. Consider launching new products. Implement a robust approach to crypto assets.

### Finally, a hot topic

Following the final ESMA reports completed one year ago, on December 15, 2023, the European Commission adopted the draft legislation on the amendment of UCITS and AIFMD related to cross-border asset management and sales notifications (notifications). Both UCITS and AIF investment funds are subject to 2 draft laws: for each type of fund, an implementation technical standard regarding the form and content of the information to be notified and the exchange of information between authorities, and a regulatory technical standard on the details of the information to be notified. The drafts are currently awaiting a decision by the European Parliament and the European Council.

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**This newsletter is based on KPMG Global report of September.**

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